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The ABA's Trust Conference In Los Angeles

Update on Marital Deduction Planning

TRUSTS & ESTATES

Volume 126, No. 2 Estate Planning and Administration Since 1904 FEBRUARY 1987

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COVER

It won't be a stroll down the Walk of Stars when trust officers meet at the National Trusts Conference in Los Angeles this month. Instead, banking officials will try to find their way through a maze of issues recently confused by tax reform.

Cover photo courtesy of the Greater Los Angeles Visitors and Convention Center.

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Trends & Developments

A Bleak Year for Corporate Giving

Corporate charitable contributions grew little or not at all in 1986, continuing a downward trend that began in 1985, when the increase rate for corporate giving slumped to 7 percent from 26 percent, the Council on Foundations has reported.

Findings from a survey conducted jointly for the Council on Foundations and the Council for Financial Aid to Education, show that coporate contributions are running more than 2 percent below last year's level and about half of the companies surveyed are reducing their contributions. The survey's results represent a reversal of the corporate giving patterns illustrated by surveys conducted between 1976 and 1984 when total contributions tripled.

Also, the decline in company contributions does not seem to be caused by a proportionate decline in corporate profits for the 439 firms participating, said Linda Cardillo Platzer, who announced the findings on behalf of both organizations. For example, non-manufacturing firms cut their combined contributions by a little more than 1 percent, yet enjoyed a 9 percent increase in profits last year, Ms. Platzer said.

However, the overall drop in giving could be linked to a year of falling profits for oil companies. Oil companies, which have always been a major contributing force, have cut their giving by 15 percent, producing a negative impact on the total rate, according to the Council on Foundations.

The study also revealed some new corporate priorities in terms of philanthropy, which are broken down in Table 1. For the first time in 10 years, companies increased the slice of the total donations pie given to health and human resources agencies.

Non-cash contributions, which have charted large gains for many years, have also dropped slightly for 1986, the survey indicates. This trend marks the end of a five-year period in which corporate donation of time and inventory, rather than money, was on the upswing. James A. Joseph, president of the Council on Foundations, attributes the change to the negative impact of more corporate mergers and acquisitions.

Table 1

Areas Where Corporate Donations Are Going

Education	38 percent
Health and Human Resources	29 percent
Community Causes	17 percent
Cultural Causes	11 percent
Religious Causes	5 percent

Property Values: Good and Bad News

U.S. home values could grow as much as 6.5 percent now that the Tax Reform Act of 1986 has taken effect, but the new tax law may have a negative impact on other properties.

That's the outlook from results of a poll of appraisers, conducted at the annual convention of the American Institute of Real Estate Appraisers.

Appraisers attending the convention expect the new tax law to slow rental development, and cause rents to rise and interest rates to fall, contributing positively to the value of owned homes.

Predictions on the value of other classes of real estate are not as happy: Second homes will lose about 1.4 percent of their value, rental apartments will lose 6 percent, hotels and office buildings will decrease in value by 5.6 percent and 5.8 percent, respectively. Retail and industrial properties are expected to drop in value by about 2.4 percent and 1 percent, respectively.

What Planners Expect

The tax reform of 1986 will slow economic growth in the nation, and tax changes will promote consumer spending rather than consumer saving. Those were the predictions of most of the professional financial planners who responded to a recent survey commissioned by the Employee Benefit Research Institute (EBRI) in Washington, D.C.

Of the 124 financial planners polled, EBRI reported that most said they will continue to recommend use of tax deferral even though three-quarters of them expect future tax rates to rise to 35 percent or more by 1995.

But the financial planners indicated that, although they still believe people in the 28 percent tax bracket should defer income if they can, they had mixed advice on strategies for people in the 15 percent bracket.

For clients age 34 to 55, who fall into the 15 percent bracket, only two in five financial planners said they would advise against contributing to a 401(k) plan if the client's employer does not make a matching contribution. One-quarter of the planners polled said individuals in the 15 percent bracket should take an employer's contribution in cash, rather than putting it into a pension plan.

Financial planners are still recommending defined benefit plans for clients over age 45, and defined contribution pension plans for those under 45, despite the faster vesting rules imposed by the new tax law, according to the survey.

Demand for real estate investments and IRAs is expected to wane, even though most planners said they would still advise people eligible for IRA deduction to use the long-term investment.

Financial products that will enjoy more popularity as a result of TRA 1986, are expected to be cash value life insurance, tax-exempt bonds and annuities.

—Laura L. Hunt

Valuation Revisited

"Lack of marketability discount" becomes an integral part of calculations in fair market valuation of closely held securities

By **PHILIP W. MOORE**
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One of the least-understood points in the fair market valuation process has been the so-called "lack-of-marketability discount." The discount factor (or non-marketability discount) of closely held company stock in arriving at a fair market value has been *qualitatively* well-recognized over the last 20 or 30 years in all U.S. courts. It is a basic and accepted part of investment practice among analysts and valuation experts, but disagreement about its *quantification* is considerable.

In business or in the world of trade, tangible assets that do not have ready markets almost always are sold at some discount — and *intangible* assets, such as securities lacking active markets, tend to be discounted even more. This is true because 1) there are oftentimes few buyers for a particular intangible and only a discount would attract a buyer; 2) the prospective purchaser of such an intangible himself, in turn, might have trouble disposing of it, and thus, find it an illiquid holding; and 3) the true value or worth of the intangible at that time is often hard to determine, sometimes difficult to prove and usually difficult to agree upon.

Indeed, in business almost all transactions (and indeed the very concept of fair market value) are the result of taking into account and balancing out all of the varied factors involved in the rather complex and classic fair market valuation process. However, in the case of many intangibles such as securities, only those equities or bonds with ready markets reflect the price arrived at for both buyer and seller by the functioning of a *marketplace* which weights all of these factors. Absent such a marketplace, prices must be set by calculation and comparison and the use of financial ratios, and "fair market value" is reached by detailed analysis and comparison.

Current professional fair market valuation practice of intangibles or closely held securities and the present interpretation of tax law (especially Revenue Ruling 59-60) calls for analysis of specified factors. These relate to the eventual price to be settled upon between a buyer and a seller, often giving varying weights to differing factors. In almost all cases however, this means taking into account how liquid or illiquid, how regularly or easily marketable, or how readily salable the particular intangible asset is, once the purchaser acquires. If there is no such aftermarket, or if there does not exist a regular, active trading market of reasonable size, depth and absorptive capacity, then there is a tendency to *discount* the value from some agreed-upon bargaining price-point. A discount is then almost always taken from that point, adjusting downward from some higher price-point (on which there is a consensus) to another agreed-upon and discounted figure, applying a discount factor whose size in turn depends upon a number of variable items, principal among them the degree of liquidity.

There are four general categories of discount which can be applied against a price-point to reach an agreed-upon lower price (and hence a fair market value) for the security under analysis. They carry different nomenclature and rationale, but all four have their basis in the reduced liquidity, salability or marketability of the security under study. The four categories are 1) non-marketability discounts (illiquidity), 2) blockage discounts, 3) restriction discounts, and 4) minority interest discounts.

As for the "lack-of-marketability" factor, a general principle can be stated roughly as follows: Shares as to which various intrinsic pricing-related ratios (based on earnings, dividends, book value or net asset value) must be resorted to for valuation guidelines in fact, *lack* the marketability possessed by shares listed on a stock exchange, or those regularly traded over-the-counter. If an active market did indeed exist, valuation measurement factors would not have to be resorted to, since in such an event the *market* would control. Where an active trading market does not exist, then extrinsic or intrinsic factors are used as valuation benchmarks — and the lack-of-marketability discount becomes operative and applicable.

It would be jejune to believe (once the valuation of closely held shares by calculated reference to earnings, dividends, book values or other measures had been performed) that such shares could be automatically or even readily sold at the exact price so computed. In the first place, it would not be an easy task to locate an interested and/or ca-

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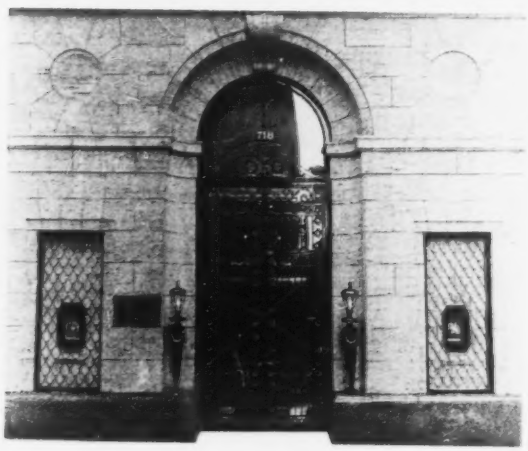

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pable buyer for the security. The Greeks had a word for this: "oligopsony," or "few buyers."

Further, it would in all probability be somewhat difficult to find a buyer at such a price who (simply because it had been computed, and with however much accuracy) would readily or quickly agree with its correctness. Finally, even if such a buyer were located and convinced as to pricing, he would still need to be shown that his purchase could be disposed of. Thus, the question of how to *quantify* a discount factor satisfactory to both buyer and seller automatically arises, especially when faced with these three problems: 1) *oligopsony* (few buyers), 2) difficulty in creating *acceptable valuation proof*, and 3) *illiquidity* of the security, all characteristic of most closely held securities.

A much-discussed decision regarding fair market valuation of closely held stock has been used for over two decades as a preamble to this problem. The Court of Claims in 1962 in a noted case (Central Trust Company — 305 F.2d 393, 405 CT. CLT., 1962), articulated the following principle: "it seems clear. . . that an unlisted closely held stock of a corporation . . . in which trading is infrequent, and therefore lacks marketability, is less attractive than a similar stock which is listed on an exchange, without ready access to the investing public."

To make allowances, therefore, for the lack of marketability or illiquidity of such shares, the courts have over the last three decades allowed a discount from the value otherwise determined for such shares known as a discount for "lack-of-marketability" or "non-marketability." The question of fact having been determined, then, the question of degree next arises. Before turning to quantification however, let us define some terms, and examine various "subsidiary discounts."

Subsidiary Types of Discounts

To start with, we must distinguish here between a discount for non-marketability or lack-of-marketability of a security due to illiquidity (absence of a ready market), as opposed to a discount due to "blockage."

On occasion, oftentimes involving estates of founders of sizeable publicly held companies, a block made up of a large number of shares may be claimed to have a fair market value lower than quoted market value, since in the eyes of the estate, the attorney or the valuation expert, the block is of sufficient

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size to affect the market in those shares adversely, if sold at that time.

Decisions of the Tax Court have permitted discounts for blockage over the past two decades, although with the increasing trading volume on stock exchanges in recent years, the depressing effect of the sale of a large block of shares on a given market may be more difficult to prove. In any case, in its Estate Regulations, the Treasury has acceded to the concept of blockage.

One should note the difference between the non-marketability principle and that of blockage as applied to shares of stock. The latter arises only when there is indeed a public market for the security in question — on an exchange or over-the-counter — and has to do with the *size* of the block of shares relative to the trading volume in those shares.

The theory of blockage is that the ongoing market for the shares would be depressed with the offering of a block of such size. Added to the normal supply of shares regularly coming into that marketplace, the block would at time of sale have a stultifying impact on normal pricing of the shares (e.g. Saul T. Steinberg — 46 TMC 1238 (1983)). Shares which have active public markets and relatively substantial volume of trading are less likely to warrant large discounts than in situations when the shares are seldom traded, or which have only "thin" markets for the shares.

On the other hand, the non-marketability concept arises from illiquidity, in cases of shares which are closely held, and which lack an active, steady or available market. Thus, a large block of a closely held company could not be said to cause blockage, since there is no active market for the shares — however large the block in question — with no market price to be affected. In such a case, of course, a non-marketability discount however could be allowed. As contrasted with blockage theory, the *size* of the block per se, would not be the basic reason for such a discount.

In the 1960s and early 1970s particularly, so-called "letter stock" proliferated, offering a special example of a discount for a very real reason, *restriction* in a stock's marketability. Blocks of such stocks usually called for non-marketability discounts of from 30 to 60 percent, arising from what could be termed a so-called "restriction discount." These letter stocks consisted of sizeable blocks of equities which *did* have a market (oftentimes over-the-counter), which were not registered with

the Securities Exchange Commission, but were stamped as representing a long-term investment, and therefore, unsalable for a period of two years. They fell out of investment fashion in the middle 1970s.

There are other types of restriction discounts applicable to both publicly held and closely held securities. Principal among the restricted-stock groups are those who are special "control person" owners of publicly held firms, who to sell any sizeable blocks of the stock must first have the stock registered, at the cost of oftentimes considerable money and time.

Because the *liquidity* and marketability of the block of stock owned is thus reduced, restriction discounts have been sought or expected in placing a fair market value on such a block. Tax Court decisions in such cases most often *combine* the restriction discount with several other discounts in arriving at an overall non-marketability discount, rather than allow a double discount for the restriction and the resultant lack-of-marketability. Hence, the size of the restriction discount by itself is most often hard to isolate in such cases (e.g. Estate of Clarence J. Grootemat — 38 TCM 198 (1979)).

When restrictions are added to the liquidity problems of a closely held security, the discount result can be trenchant. Already burdened with the lack of ready market for its shares under even untrammeled circumstances, the presence of a prior restriction on the stock in question can only add fuel to the already-burning discount fire (e.g. Virginia Z. Harwood 82 T.C. No 23 (1984)).

Restrictions do have the advantage, of course, of being removable under some circumstances, but lacking such hope of relief, they can be potent factors in increasing the lack-of-marketability discounts in such situations.

Minority Interest

There is another type of discount often applied to a block of closely held stock which by its small relative size as compared to company capitalization represents a minority interest in the company that is to be valued. Such minority shares of closely held firms are considered in practice (and by many courts) to carry almost an automatic lack-of-marketability discount, with discount applicability a matter of degree, not of kind.

It is fairly evident that the reason for allowing a discount when valuing shares which represent a minority interest in closely held shares runs along the same line as that for non-marketability discount as discussed earlier — but with several additions. First of all, those shares could probably not be sold at the same price at which publicly held shares with generally similar financial results (earnings, dividends, book value, etc.) could be sold. Second, as compared with a control block of shares, the minority block would undoubtedly sell for less partly because of the block's powerlessness to affect the company's ongoing future in any substantive way. (Indeed, a review of the last two years of takeover and leveraged buy-out activities could lead to the somewhat cynical conclusion that the minority block stockholder even in public companies could almost be classed as a second-grade or lower-tier corporate citizen, with the value of his shares discounted well below those shares representing control.)

In the case of minority interest discounts, court decisions would not seem to favor two separate discounts, i.e. for minority interest as well as non-marketability. They generally show only the single discount, rather than breaking the discount down into two figures. Examination of court decisions indicates that minority interest more and more is being regarded as an important discountable factor by the courts, leading to and almost axiomatic with impaired marketability. Minority interest can often increase the size of the overall discount allowed by considerably more than just the lack of a market for the shares. In addition, some courts apparently feel that lack of liquidity or non-marketability can be remedied by various methods, while a minority interest situation cannot.

One other point should be mentioned here as related to a block of minority shares. The non-marketability principle can be applied to shares which represent control as well as to minority shares. A control block could thus also suffer from non-marketability like the minority interest block, but would be free of the burden of the discount inherent in the minority position.

Indeed, the courts have been known to separate these concepts, and to allow two separate discounts (Whittemore vs. Fitzpatrick 127 F. Supp. 710 DC Conn 1954). More frequently, the court will place its emphasis on one concept or the other, and allow only a single discount. For example, in Central Trust Company (op. cit. 1962) the Court of Claims discussed lack-of-marketability, and then stated that "a consideration of this factor is appropriate, especially where as here only a minority interest is involved."

We have made a recent analysis of about a dozen leading Tax Court cases featuring minority discounts, from 1950 to 1982. Our analysis indicates that the size of the minority discounts allowed ranges from 10 percent to 35 percent, depending upon a number of factors. The median figure for the 10 cases was a 25 percent discount for minority interest. This discount size can be compared to our later chart on the trends in non-marketability discounts over a similar period. (See Chart 1.)

As we have noted, so-called minority interest discounts can vary sharply in size. Depending on the nature of a given

CHART 1

Minority Interest Discount Citations

Citation	Discount	Taken From:
14 T.C. 611 (1950)	25%	Book Value
19 T.C.M. 281 (1960)	20%	Discounted Net Asset Value
46 T.C. 461 (1966)	30.4%	Book Value
48 T.C. 86 (1967)	84%	Book Value
28 T.C.M. 783 (1969)	25%	Discounted Net Asset Value
31 T.C.M. 814 (1972)	33%	Appraised Value of Controlling Shares
35 T.C.M. 1389 (1976)	25%	Appraised Value
36 T.C.M. 375 (1977)	10%	Appraised Value
69 T.C. 32 (1977)	15%	Appraised Net Asset Value
43 T.C.M. 427 (1982)	50%	Appraised Value

CHART 2

Valuation Pricing Decisions by the Tax Court, 1969 - 1984
(selected cases related to lack of marketability)

Date of Decision	Case	Amount of Discount	Taken from Discount/ over Premium	For	Citation
1969	*Estate of Gregg Maxcy* Valuation of Capital Stock: 8/10/61 (a) 5/24/63 Judge Forrester - Estate Tax	15%	Net Asset Value	Lack of Marketability	28 T.C.M. 783
1973	*James R. Williams* Valuation of Common Stock: 9/1/66 12/18/67 Judge Tietjens - Gift Tax	15%	Appraised Value	Lack of Marketability	32 T.C.M. 759
1973	*Estate of Donald M. Hayes* Valuation of Common Stock: 6/24/67 Judge Hall - Estate Tax	25%	Appraised Value	Lack of Marketability	32 T.C.M. 1102
1976	*Estate of Victor P. Clarke* Valuation of Capital Stock: 5/2/69 Judge Sterrett - Estate Tax	20%[1]	Appraised Value	Lack of Marketability	35 T.C.M. 1482
1978	*Estate of Tully v. U.S.* Valuation of Common Stock: 3/7/64 Judge Fletcher - Estate Tax	20%	Appraised Value	Lack of Marketability	78-1 U.S.T.C. 13,228
1978	*Estate of J. E. O'Connell* Valuation of Common Stock: 4/8/73 Judge Dawson - Estate Tax	30%	Appraised Value	Lack of Marketability	37 T.C.M. 822
1978	*Richard O. Wheeler* Valuation of Debentures: 5/23/62 Judge Irwin - Income Tax	25%	Face Value	Lack of Marketability	37 T.C.M. 883
1978	*Richard O. Wheeler* Valuation of Common Stock: 5/23/63 Judge Irwin - Income Tax	10%	Face Value	Lack of Marketability	37 T.C.M. 883
1979	*Estate of William T. Piper, Sr.* Valuation of Common Stock: 1/8/69 Judge Tannenwald - Gift Tax	35%	Discounted Net Asset Value	Lack of Marketability	72 T.C. 88
1980	*Rudolph H. Maris* Valuation of Common Stock: 12/23/74 5/12/75 Judge Dawson - Gift Tax	30%	Earnings Per Share	Lack of Marketability	41 T.C.M. 127
1981	*Campbell, Jr. v. U.S.* Valuation of Common Stock: 11/29/68 Judge Wiese - Income Tax	43%	Appraised Value	Lack of Marketability	81-1 U.S.T.C. 9450
1982	*Wallace v. United States* Valuation of Non-Voting Common Stock 10/16/72 11/1/72 Judge Keeton - Gift Tax	50%	Appraised Value	Lack of Marketability	44 T.C.M. 258
1982	*Maalpin v. United States* Valuation of Gas Royalty Interests: 1/5/76 Judge Senter, Jr. - Estate Tax	10%	Appraised Value	Lack of Marketability	82-2 U.S.T.C. 13,490
1982	*Capital City Excavating Co., Inc.* Valuation of Common Stock: 12/31/75 Judge Hamblen - Excise Tax	10%	Net Asset Value	Lack of Marketability	47 T.C.M. 1527

[1] Petitioner(s) Expert Witness

span was about 35 percent — and the ranges were widening, with the high end rising from 25 to 35 to 50 percent over the three periods. Without attempting to place absolute, statistical reliance on the array, this would seem to us to indicate a more liberal view (or a more practical one, or a more flexible one) of the significance of marketability and liquidity in the fair market valuation process by the Tax Court.

The Key — Lack of Liquidity

It should be clear that such discounts for lack-of-marketability and minority interest are an integral part of the fair market valuation process today. As for the general principle of lack-of-marketability however, and the applicable discounts therefor, it should be remembered that *anything* which adversely affects the liquidity, the salability or the marketability of the security in question must reduce the value of that security by some degree. "Lack-of-marketability" can have many causes (such as, say, minority interest) but the effect of the investor's *perception of a weaker liquidity* of the security is the governing point, not its powerlessness or other inherent disadvantages. Minority interest is therefore a subset of lack-of-marketability, as are blockage discounts or restriction discounts, since they *all work to reduce the liquidity or salability of that particular block of stock* to some further degree, even beyond the discount inherent in the closely held character of the equity.

The IRS' View

We have glimpsed from the above analysis that lack-of-marketability discounts for closely held company stock are *qualitatively* part of the valuation fabric, and that *quantitatively* such discounts seem to be somewhat larger today than was true of them 15 years ago. Further, the discount more and more seems to be taken from appraised value, rather than from asset value, book value or other benchmarks.

Our practice and that of other valuation appraisers plus court decisions, (including Tax Court results) would seem to bear out these broad conclusions rather clearly. Non-marketability discounts today then would seem a standard part of the valuation mechanism — if such a subjective discipline may be said to possess such an attribute. Most professional texts on the subject would seem to agree with real-life valuation practice and with Court decisions as to the application of reasonable numerical discounts applied to the appraised value of a closely held security in reaching an acceptable final price-point, which is fair market value.

The IRS, however, edges away from the subject, and seeks to avoid placing any limits or measures on the degree or extent of any discount for non-marketability. In the *IRS Valuation Guide (1982),*[2] (a course for IRS agents in valuation concepts and techniques for income, estate and gift taxes), the IRS text comes out with a strong prohibition against specific rules of thumb or flat percentages as to lack-of-marketability discount, and goes on to say, "in no case should arbitrary percentage discounts be resorted to as an answer to the claim of lack-of-marketability."[3]

Following the strictures of Revenue Ruling 59-60, the IRS contends there are an infinite variety of pertinent factors affecting a stock's fair market value, and that marketability — or lack thereof — is only one of them. Therefore, the agent is cautioned to judge each situation on a case-by-case basis.

The IRS does agree however, that on closely held company stock, substantial discounts are often called for, based on lack-of-marketability. It is important to note that in this context, the *Valuation Guide* also points out, "it is axiomatic that the value of a stock is reduced by anything which tends to reduce its marketability."[4]

The IRS *Guide* does point up succinctly the subjective nature of the fair market valuation process, while at the same time admitting that lack-of-marketability is indeed a factor which can impinge itself significantly upon a price-point in reaching a fair market value. In this regard, the IRS *Guide* has this thought-provoking paragraph: "The extent, however, to which any restriction or limitation on marketability will reduce the value of a specific stock as of a certain date is entirely a matter of opinion. Appraisers can therefore let their conscience be their guide in reducing values for the all-encompassing factors of marketability."[5]

They do hint that there are more effective ways to deal with arguments about marketability, reducing the value of a stock, such as to "indicate that (the agent) has taken it into consideration in (his) overall appraisal of the stock,"[6] and, for that reason, has applied a conservative capitalization rate, or lesser weights for certain other financial factors, or lower multiples — all this without actually admitting that a numerical lack-of-marketability discount should be applied to an indicated or calculated equity price.

Summary

In the past three or four years, the liquidity of the U.S. economy as a whole has vastly improved, and this new factor is reflected in almost all types of financial markets. It would be very much to be expected, therefore, in valuing closely held securities, that a tendency toward greater discounts in these times would be observed, especially if that discount were occasioned by a perceived lack of today's quite common liquidity.

Thus, the lack-of-marketability discount has not only gained acceptance in recent years, but has become an integral part of the intrinsic and extrinsic calculations that comprise standard and accepted methods in the fair market valuation of a closely held security.

The foregoing analysis, therefore, indicates rather clearly that while a case-by-case approach must be made in each valuation, a lack-of-marketability discount is as much a part of basic appraisal calculations today as is the price-earnings multiple. Its widening qualitative acceptance has led in r cent years to certain benchmarks or ranges of quantitative application of such a discount, in the continually refining fair market value process. □

FOOTNOTES

1. Such blockage discounts vary in magnitude, but can run in size from 3 percent to as much as 50 percent of the block's value. We have examined 15 Tax Court cases from 1950 to 1983, and the blockage discount varied from 4 percent to 52.9 percent.

2. *IRS Valuation Guide for Income, Estate and Gift Tax* (IRS Appeals Offices Valuation Training Programs) Published by Commerce Clearing House, Inc. Chicago, Ill. *Estate and Gift Tax Reports*, May 1982; 220 pages.

3. op. cit. p. 126
4. op. cit. p. 127
5. op. cit. p. 128
6. op. cit. p. 126

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